The Canadian Chartered Accountant

- **How the U.S. Taxes Aliens**
  by Gustave Simons
- **The C.A. as a Principal**
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- **Falsification of Records**
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THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

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COMMENT AND OPINION

The Acceptance of LIFO

MR. Justice Thorson's judgment in the *Anaconda* case in which the legitimacy of LIFO was recognized is not likely to be the final word. There remains the possibility of an appeal by the Minister to the Supreme Court of Canada, and, apart from that, the case was decided under the Income War Tax Act, which, unlike the new Act, contains no provision whatever on the subject of inventory valuation. Moreover, Mr. Justice Thorson was very careful to confine his recognition of LIFO within the confines of the circumstances of the case before him, and there is nothing in his judgment to suggest that it will be recognized in different circumstances.

The gist of his judgment is contained in the following passage.

> I have come to the conclusion that where a manufacturing company avoids speculation or trading in its materials and makes the sales price of its finished products closely reflect the current replacement cost of the materials content and matches its purchases to its sales of finished products so that the inflow of the materials equals the outflow of the materials content of the finished products and it must continuously maintain a large inventory and the rate of its turnover is slow the LIFO method of inventory accounting and ascertaining the materials cost of its sales for the year is the method that most nearly accurately reflects its income position according to the manner in which it carries on its business and is the method that ought to be applied in ascertaining the materials cost of its sales and determining its net taxable income.

Whether or not the use of LIFO will be recognized, for tax purposes of course, in a wider range of circumstances than these remains to be seen.

The judgment of Mr. Justice Thorson also touches on a related question, namely who has the right to choose the method of inventory valuation where two or more methods are equally appropriate, the taxpayer or the Tax Department? On this point His Lordship said:—

> Under the circumstances, I find that the LIFO method was appropriate in the circumstances of the appellant's business. This means that it was entitled to use the method in ascertaining the cost of the metal content of its finished products that was properly chargeable against its gross income for sales and that the method correctly reflects its net taxable income in 1947 and I so find. It follows that the appeal from the assessment for 1947 must be allowed.

Having so decided, Mr. Justice Thorson adds:

> While I need not say more I also find that the method employed by the Minister in arriving at his assessment [FIFO] was not a proper one. This is not a case in which either of two accounting methods is acceptable. Only the one method, the LIFO method, is appropriate . . . It seems plain to me that when a company so conducts its business as to avoid the risk of profit or loss through the rise or fall of

its raw materials its income position cannot be correctly determined if so-called inventory profits or losses which it has not earned or sustained are brought into its accounts. To do so is to use an accounting system that is not in accord with its business policy and practice and does not fairly reflect its income position.

It is clear from this that in Mr. Justice Thorson's view the Tax Department was not entitled under the Income War Tax Act to compel the taxpayer to employ a different method of inventory valuation than the method chosen by the taxpayer where the method chosen by the taxpayer was appropriate in the circumstances of the taxpayer's business and correctly reflected his income therefrom. Whether his opinion would have been the same had the appeal been taken under the new Act is, however, another question.

An Important Pronouncement

THE Council of the Institute of Chartered Accountants in England and Wales has recently issued an elaborate amplification of its earlier recommendation on Rising Price Levels in Relation to Accounts. Conceding that the significance of accounts prepared on the basis of historical costs is subject to limitations by reason of the lack of stability of the monetary unit in which accounts are expressed, the Council examines the various alternatives which have so far been suggested, namely the replacement cost method of dealing with fixed assets, the writing-up of fixed assets, the current value method of dealing with inventories and depreciation of fixed assets, and the index method of adjusting accounts to reflect changes in the purchasing power of money. Its conclusion is that the adoption of any of these suggested alternatives would raise much wider questions than the computation of business profits alone.

If, says the Bulletin, a different conception of profit were substituted for the present method based on historical cost, it would not merely be every business which would be affected but also every individual. For example, would adjustment not be required to be made of the legal rights arising under investments in bonds and stocks, leases, pension contracts, insurance policies, service contracts and profit-sharing schemes, etc.? Would it not affect the determination of prices of goods and services to enable payment of a fair return to investors or indeed to make a profit at all, in other words, result in a further fall in the purchasing power of money and thereby aggravate the problem? Would it not affect the proportions of the total tax burden to be borne by different classes of taxpayer? For example, in a period of rising prices it would relieve businesses of a large amount of taxation and therefore raise the further question of how that relief should be distributed over other taxpayers. Would it not also affect the raising of new capital if it is to be laid down that before dividends can be paid the purchasing power of the capital employed in the business must be maintained, as compared with the existing position under which the distribution of monetary profits is a matter of policy for the directors?

These are only some of the problems which would arise, the Council points out, and its conclusion is that unless and until a practicable and generally accepted alternative is available historical cost should continue to be the basis on which annual accounts should be prepared and profits computed, and that any amounts set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affairs of the business should be treated as an appropriation of profits and not as a charge in arriving at profits.

How the U.S. Taxes Aliens

By Gustave Simons

A concise description of the American tax treatment of aliens, with particular reference to Canadians

AN ALIEN is subject to United States tax in any one of the three following cases:

(a) If he becomes a "resident alien" in the United States;

(b) If he engages in business in the United States; or

(c) If he receives certain types of income from sources within the United States.

I. Resident Aliens: Important Points to Remember

(a) Resident aliens are taxable on income generally in the same way as United States citizens. They must file their regular returns, pay the same rates, include income from sources outside as well as inside the United States (a foreign tax credit is allowed if their homeland reciprocates this privilege to United States citizens). Exemptions, credits for dependents and deductions are also the same.

(b) An alien is considered a resident of the United States when he is actually present in the United States and is not a mere transient or sojourner. All aliens are presumed to be nonresidents. This presumption may be defeated. A person whose stay is limited by the United States immigration laws is generally a non-resident. A definite intention to return to his native country continues the alien as a non-resident unless the definite time is very far in the future and he meanwhile makes his home in the United States. A vague and indefinite intention of returning does not render the alien a non-resident.

(c) Domicile and residence do not necessarily mean the same thing for United States tax purposes; residence controls. A married alien woman resident in the United States with a husband domiciled and resident in another country is domiciled abroad but resident in the United States and taxable there as a resident alien. But an alien once resident in the United States can become a non-resident by leaving permanently. A mere intention to leave the United States and even an absence of six months are not sufficient.

An adaptation by the author for Canadian publication of an article published in *The Australian Accountant*, April 1952 and in *Taxes, the Tax Magazine*, April 1951

(d) The tax law limits the departure of aliens from the United States. An alien may not leave the United States unless he obtains from the collector a certificate that he has met his tax obligations. However, this provision is usually not enforced in the case of brief, casual trips to the United States for pleasure. On departure the Commissioner may declare the tax year of such alien immediately closed, prorate exemptions and assess the tax. This is done only if tax evasion is suspected. In other cases, the alien must present a certificate of compliance with tax obligations executed by a local collector or revenue agent in charge. This involves either the filing of a special return and payment of the tax or the appointment of a resident attorney in fact to make the regular return plus payment or the posting of security for the payment of the estimated tax due.

(e) If a non-resident becomes a resident or a citizen in the middle of the year, the computations are separate for each period, depending on the applicable rule for that period. But one return only need be filed.

II. Nonresident Aliens Engaging in Trade or Business in the United States

(a) An alien performing personal services in the United States while a temporary resident is not held to be engaged in trade or business if he (1) receives compensation of less than $3,000, and (2) is present in the United States for no more than ninety days, and (3) performs such services for a non-resident alien, partnership or foreign corporation not engaged in United States business.

(b) A mere ownership of one or two parcels of real estate does not necessarily constitute the carrying on of a trade or business in the United States. But the ownership and management of any considerable amount of real estate will be held to constitute carrying on a trade or business.

(c) If a partnership does business in the United States, an alien partner is also held to be doing business there.

(d) The ownership of stock in a corporation doing business in the United States does not bring in the stockholder as well. The mere ownership of corporate stock, in the absence of an agency relationship or personal activity of the stockholder here, is not enough. However, the Bureau of Internal Revenue is asserting in some cases that a wholly-owned United States selling subsidiary is in effect the agent of the foreign parent corporation, and care must be given to protection against such a claim.

Transactions Through Brokers

(e) The purchase and sale of securities or commodities does not constitute doing business if done through a broker, special commission agent or custodian, and if the alien, partnership or foreign corporation has no office or place of business in the United States from which those deals are managed or a general agent in the United States empowered to make policy decisions.

(f) A trust may have a situs in the United States and be taxable in the United States, but this will result neither in a non-resident trust grantor nor a beneficiary being held to be doing business in the United States in the absence of an agency relationship.

(g) The resident alien is generally subjected to the same tax as the United States citizen, including the regular tax on income from sources without the United States. A non-resident alien doing business in the United States is taxed only on income from sources within the United States.

(h) Returns for non-resident aliens engaged in trade or business in the United States must be filed on June 15, or on the 15th day of the sixth month following the close of a fiscal year. No splitting of income between husband and wife is permitted. (Therefore, if most income is from United States sources, there may be an advantage in an alien married couple establishing that they both reside in the United States.) If the non-resident alien is subject to withholding tax, he must nevertheless file a declaration of estimate tax and final return unless his sole United States income is compensation for personal services and does not exceed $600. The return should be filed with the collector within whose district the legal residence or place of business is located. In the absence of such, the return should be filed with the collector in Baltimore, Maryland.

(i) Any agent or representative for a non-resident alien doing business in the United States who receives income from sources within the United States within the scope of his agency must report that income on behalf of his alien principal and pay the tax. The mere collection of dividends or interest on securities does not come within this special provision.

(j) A non-resident alien doing business in the United States is taxable under United States laws only on income from sources within the United States.

(k) Interest is taxable when paid by a United States citizen. Also taxable is interest paid by a resident alien or domestic or resident foreign corporation if at least 20% of the gross income of the obligor for the three years before payment has been from United States sources. This applies to interest paid abroad on a foreign deposit by a United States corporation. Interest on bonds of the International Bank or of foreign government is not included.

(l) Dividends are taxable if paid by a United States corporation and if for the prior three years at least 20% of its income has been from United States sources. In the case of foreign corporations, the percentage is 50% and the dividends are taxable only in the proportion of United States to foreign gross income.

Mr. Gustave Simons, a partner in the firm of Simons, Schur & Straus, New York, is an attorney, economist and dairy farmer. He belongs to the National Association of Cost Accountants, the Society for the Advancement of Management, the American Marketing Association, and the American Bar Association.

Compensation for Personal Services

(m) Compensation for personal services is taxed to a non-resident alien engaged in business in the United States unless: (1) the alien was present in the United States for no more than ninety days, the amount did not exceed $3,000 and the work was done for a non-resident alien, partnership or corporation, itself not engaged in business in the United States, or (2) the services were performed without the United States. Services by an agent in the United States do not come within exception (2) even if the agent is outside the United States. An agreement not to work or compete in the United States does not come within the exception. Income in both these cases is from United States sources. Pro-ration of income for services within and without the United States is on a time basis unless there is some express pre-arranged apportionment. Employment contracts should cover this with care.

(n) A non-resident alien doing business in the United States is not subject to United States tax on the sale of real

estate outside the United States. Rentals from property situated in the United States are taxable; so also are royalties from United States patents, secret processes, formulas or copyrights and the like.

(o) A non-resident alien is taxed on sales of property outside the United States if he purchased or produced that property within the United States. He is taxable on sales within the United States on property purchased or produced outside of it.

(p) A sale is made where title passes to the buyer. With a C. I. F. contract, the Bureau generally asserts that title passes upon delivery to the carrier even though security title is reserved by the seller. However, the intention of the parties controls.

(q) The alien is taxable on partnership income to the extent a United States partnership itself derives income from sources within the United States.

(r) The alien beneficiary is subject to United States tax upon his distributable share of the income of a United States or foreign trust to the extent that the trust itself derives such income from sources within the United States. Trusts deriving income from within and without the United States and having United States and alien beneficiaries should have very carefully drawn income-allocation clauses to avoid unnecessary taxation.

Discharge of Debts

(s) If United States income is used to discharge a debt of the alien or if any income is used to discharge a United States debt of the alien, it is taxable. Gains upon the liquidation of a United States corporation or upon collection of insurance on the loss of goods in the United States (but see special provisions applying to involuntary conversion) are taxable. Also taxable are federal income taxes withheld, annuity income (but see the 3% rule) and damages for breach of contract to be performed in the United States.

(t) Only expenses, losses or other items of deductions attributable to the production of income within the United States are deductible. Thus, alimony which may be deducted by a resident alien or United States citizen may not be deducted by a non-resident. If some item such as this exists or if foreign losses exceed foreign gross income, it may be advantageous for a non-resident to qualify as a resident.

(u) A non-resident alien becomes a resident alien by presenting proof that he has:

(1) Filed a declaration of intended naturalization;

(2) Filed Form 1078;

(3) Committed acts evidencing, and made statements of, a definite intention to acquire United States residence; or

(4) Stayed in the United States long enough to render him a United States resident.

Deductions

(v) Deductions are allocable to United States income in the case of a non-resident by demonstrating a specific causal connection. For example, if a non-resident alien employs a United States agent in the production of United States income, the agent's commissions are specifically allocable to such income. If specific allocation cannot be made to the United States on foreign income in connection with certain expense items, these items will be pro-rated between United States and foreign income. It is dangerous, however, to rely on such pro-ration, and it is best to keep accurate and detailed records and make such allocation in advance where possible. Mere inability to allocate expenses to foreign sources does not create any assumption

that they are allocable to United States sources.

Some items are specifically held to be not deductible. Interest on a debt incurred to finance non-United States business and stock losses in non-United States corporations are not deductible. Charitable contributions are deductible only if made to United States charities and similar institutions. Losses on the destruction, theft or loss of property are also deductible if the casualty or loss occurred in the United States.

The loss does not necessarily have to be connected with the non-resident's United States business. If a transaction was entered into in the United States with the intention of creating a United States income or gain, a connected loss may be deducted even if it was not the alien's principal business and even if the transaction resulted in a loss rather than a profit. Of course, the United States' rules about the general deductibility of non-business losses also apply.

An alien may deduct United States travelling expenses and cost of lodging. However, the United States Supreme Court holds that if a taxpayer works steadily and chiefly at a certain place, that place becomes his "home" and the cost of travel to that place and of lodging there is personal and thus not deductible by anyone.

Tax Rates

(w) The tax rates applicable to the United States net income of a non-resident alien doing business in the United States are the same as those applicable to income of United States citizens, except that the so-called optional tax table may not generally be used. Canadians and Mexicans have one special advantage in that they receive an exemption of $600 for a spouse and the standard dependency exemptions. Other aliens are limited to their own exemption of $600 a year.

III. Taxability of Income of an Alien Who Does Not Reside in the United States and Who Does Not Do Business There

(a) Income is taxable under United States law if: (1) it is income from sources within the United States and (2) it is fixed or determinable, annual or periodical. The second limitation does not apply in the case of a non-resident alien doing business in the United States; he is taxed on all income from United States sources, whether regular or not. Neither limitation applies to the resident alien. He is taxed upon all income even if it is not from United States sources and not regular. Income from sources within the United States is defined as in the case of non-resident aliens carrying on business in the United States.

(b) Income items which are considered "fixed or determinable", "annual or periodical," include interest (except on bank deposits), rents, royalties, dividends, wages, salaries, annuities, premiums, compensations, emoluments.

(c) A special commission exists for royalties. Even a lump-sum payment for part of a copyright, for example, motion picture rights, or part of a patent has been held to be a royalty by the United States Supreme Court. On the other hand, where full rights in a total United States patent or copyright pass for a stated price, it has been held that even if the price is paid in installments measured by production or income, the payment is not a royalty. However, in such a case the payor may be compelled to capitalize such payments as an investment and be disallowed an expense deduction from his income.

Interest on Bank Deposits

(d) By special provision, interest on bank deposits is exempt from tax. If a resident trust collects interest on a bank deposit and later distributes it to a non-

resident, the interest loses its exemption. Interest on obligations of the United States issued prior to March 1, 1941, is exempt. By constitutional interpretation, interest on state or municipal bonds is, of course, exempt in the hands of all persons.

(e) Dividends are taxable to aliens while capital gains generally are not. The redemption of stock at more than its cost ordinarily creates a capital gain, but the redemption may be essentially equivalent to a dividend, as when stock is redeemed, pro rata, from all stockholders. In that case, there will be a tax levied, probably, on the entire sum paid if paid out of accumulated or current earnings.

(f) Compensation is taxable. Prize money is taxable generally as compensation. Commissions are also so taxed, although an isolated commission on a single transaction may escape.

(g) Rent is also taxable. In addition to regular rent, if the tenant pays taxes, interest or other obligations of the landlord, these payments are treated as rent. Thus, not only is a net rental after taxes taxable but the taxes themselves are treated as taxable income. Payment of rent in advance or as security is currently taxable unless a segregated trust fund is set up.

(h) Unlike the case of a non-resident alien who does business here, gains from the sale of real estate or personal property are exempt from tax even if the property is in the United States or if the sale occurs there. However, the occurrence of such sales frequently may result in the alien's being treated as engaged in business within the United States and render him taxable. Also, what may look like a sale may be treated as a lease or licence if even partial title is retained by the alien, thus producing taxable rent or royalties instead of tax-exempt gains. Furthermore, special regard must be given to the Revenue Act of 1950 which is discussed later in this article.

(i) The tax is 30% of the gross income. However, if the gross income exceeds $15,400, the alien must compute his tax on the thirty per cent of gross income basis, and, alternatively, on his net income at regular rates (with deductions, exemptions and credits generally limited). The higher alternative tax is then due.

Withholding Tax

(j) Withholding is provided in order to facilitate collection of taxes due from aliens. This tax must be withheld from the income of all non-resident aliens, whether or not engaged in business here. The tax must also be withheld by a partnership having any alien partners, or a foreign corporation if not engaged in business in the United States. The withholding provisions apply to the type of income from sources within the United States which is taxable in the hands of a non-resident alien not doing business in the United States.

The following are among those who must withhold: lessees; mortgagors; fiduciaries; employers; a resident record owner of stock held for the benefit of a non-resident alien; a husband receiving community income from a non-resident alien wife; an obligee who pays income to a trust for the benefit of foreign beneficiaries or one who pays to a foreign trustee for the benefit of United States citizens or residents themselves liable to withholding; any person who deposits income in an alien's bank account; one who pays to the agent of a non-resident; a corporation distributing dividends or making payments in partial or complete liquidation. A mere guarantor who makes no payment, need not withhold. So also for a person who pays accrued interest when selling bonds between interest dates, and one who re-

ceives Form 1078 or its equivalent certificate of residence and forwards it to the Commissioner, Withholding Return Section, Washington, D.C.

(k) There may be certain exceptions as to withholding. A Canadian or Mexican or any agricultural laborer who enters and leaves the United States at frequent intervals is not subject to these provisions. However, the regular provisions as to withholding taxes on compensation paid to any United States citizen or resident may apply. (The rates differ.) Dividends paid by foreign corporations are subject to withholding if the corporation is engaged in business in the United States and more than 85% of its gross income was from United States sources for the three previous years.

Withholding returns must be filed by March 15th. The withholding agent is personally liable for the tax unless the alien pays it. Corporations paying interest must also file monthly rates on the 20th of each month for the prior month in respect of such interest. The withholding rate is 30%.

IV. Effective New Revenue Laws and Tax Treaties

(a) The 1950 Revenue Act is of special interest to aliens enjoying United States capital gains. It partially terminates the exemption from tax of a nonresident alien not engaged in business in the United States. If such alien is present in the United States in any year for periods aggregating 90 days or more, capital gains accruing at any time during his taxable year are taxable. If present in the United States less than 90 days, only capital gains on sales or exchanges during his stay here are affected. The tax is on the excess of his gains from United States sources over his losses from the same sources during the taxable period. Unlike the provisions applicable to residents or those engaged in business here, a long-term gain is included in full (not at 50%) and the five-year carry-over of net losses does not apply. The tax rate is 30%. The net gain is included in the computation of the $15,400.00. These provisions are expressly subordinated to contrary provisions of international tax conventions.

Canada-U.S.A. Tax Convention

(b) A special tax convention exists between the United States and Canada, retroactively effective from January 1, 1941. Supplementary income tax and estate tax conventions were signed on June 12, 1950 and the instruments of ratification of the supplementary conventions were exchanged on November 21, 1951. This supplementary income tax convention is effective for the taxable years beginning after December 31, 1950. These and other treaties with foreign countries take precedence over all United States revenue laws.

Commercial and industrial profits derived from the United States, if not derived from a permanent establishment in the United States, are exempt to Canadian treaty aliens. This exemption, however, does not apply to rents, royalties, interest, dividends, management charges or capital gains. A mere purchase of merchandise by a treaty alien is exempt from tax. Likewise, income from the operation of a ship or aircraft by a Canadian is exempt from tax. Annuities and pensions paid to Canadians are similarly treated.

A resident of Canada is exempt from United States tax on compensation received for personal (including professional) services in the United States if he is in the United States not more than 183 days in the year and 1) either his services are rendered as an officer or employee of a resident, or corporation or other entity of Canada, or 2) the compensation received in aggregate during

the taxable year for such personal services does not exceed $5,000.

Canadian treaty aliens are also tax exempt on United States capital gains; dividends from United States subsidiaries are subject to only a 5% withholding tax.

A resident Canadian professor or teacher who temporarily visits the United States for the purpose of teaching, for a period not exceeding two years, at a university, college, school or other institution in the United States is exempt from U.S. tax on his remuneration for such teaching for such period.

All persons affected by United States taxes should watch the action of Congress. Legislation such as the Revenue Act of 1950 which changed the law concerning capital gains of aliens can be vital. Furthermore, the decisions of the United States Tax Court, the district courts, the circuit courts and the Supreme Court, as well as Treasury rulings and regulations, must be carefully and continuously studied. For example, the Supreme Court decision in the case of the famous author, P. G. Wodehouse, changed the definition of capital gains, subjected Wodehouse to heavy taxes and affected authors all over the world. Such study will readily reward all persons in all lands.

ENGLISH SPOKEN HERE

Language is the vehicle of thought. Its object is to move thought from one place to another — from our mind to the other man's. Why, then, clog our language and our letters with words which have no virtue but length, phrases which have no virtue but antiquity and sentences which have no virtue at all?

A plumber wrote to the Bureau of Standards in Washington for some advice. He had discovered that hydrochloric acid worked wonders in clogged drains but he wanted to know if it was safe to use.

His letter brought the following reply from one of the bureau's experts: "The efficiency of hydrochloric acid is indisputable, but the corrosive residue is incompatible with metallic permanence."

The plumber wrote back to thank the bureau for letting him know his method was okay.

This so upset the federal scientist that he consulted his immediate superior, who in turn wrote the plumber: "We cannot assume responsibility for the production of toxic and noxious residue with hydrochloric acid and suggest you use an alternative procedure."

Again, the plumber replied he was glad to know the bureau approved of hydrochloric acid. This time the two scientists appealed to the head of the bureau. He closed the file by dictating this: "Don't use hydrochloric acid. It eats holes in the pipes."

—*The Port Elgin Times*, May 1952

The C.A. As a Principal

By Gertrude Mulcahy, B.A., C.A.

Each student, with his peculiarities of character and ability, presents a unique problem to his guide and mentor

INCREASING COMPETITION in the accounting profession and increasing demand for accounting services have created a critical need for thoroughly trained young men who can meet the high standards of the profession. In consequence, practising members of the profession should take stock of the efforts they are making to meet this need and to fulfil their responsibilities to the young men coming under their guidance. Have they, in seeking to serve their clients, forgotten their obligations to their students and, perhaps (unworthy thought) tended to look on them as a source of low-paid labour?

What a Profession Demands

A profession, it has been said, demands of its members high intellectual attainments, which can be acquired only by long and arduous preliminary training. The student cannot attain these by his unaided efforts, because no matter how extensive his acquaintance with the theory of accounting, he will never be an accountant or auditor until he has learned to apply the theory in actual situations.

The chartered accountant's degree may be compared to a sports trophy. Each represents the realization of an ambition. As our home team sweeps to victory on the football field, we cannot fail to admire the skill and ability of the coach and his assistants whose training has made victory possible. To the coaches, standing on the side lines, has fallen the task of coordinating the individual qualities of the players and of instilling in them, through ceaseless practice, the fundamental principles necessary for success. The responsibility of the partners of an accounting firm to their students is primarily the same. Each of them must, by precept and example, produce students who completely satisfy the standards of the profession.

From the time the young audit clerk, full of energy and ambition, first clutches his green pencil, eager to make his impression upon the business world, until the time that his parchment reward is bestowed on him, his training is the responsibility of his employer. As parents are judged by the behaviour of their children, so will a firm of accountants be judged by the capacity of the young chartered accountants which they turn out. Here are a few suggestions that may be helpful to those upon whom this responsibility falls.

On being assigned a student, the senior or supervisor should at the outset take time to describe the nature of a chartered accountant's function in the conduct of business and in the maintenance and development of our social and economic structure. On entering this profession, a young man becomes a cog in the great wheel of service which is kept in continual motion for the satisfaction of the needs of the public. The wheel will run evenly, however, only if each component part bears its burden, and the student should be made to realize that though a very little cog in the machine at his present stage of development his is an important function in its proper operation. The ultimate goal should be set before him as one which he can attain by the conscientious fulfilment of the tasks assigned to him.

Each Student a Unique Problem

Each junior, with his own peculiarities and abilities, presents a unique problem to his senior and supervisor. To one young man certain abilities are almost intuitive whilst in another the same abilities must be developed. From the outset the senior and supervisor must make every effort at understanding each of his students. To each of them he should be a friend who is willing to answer their questions and to help them over the first stumbling blocks of confusion and bewilderment. The concept of the senior as a minor divinity, demanding services from his subordinates, must, of necessity, be replaced by the idea of the senior as a guide and counsel.

In allotting work to the members of his staff, the senior must be absolutely certain that each of them understands his task and the reasons for it. Every detail of the procedure and of the related records should be carefully described and discussed before the work is begun. The junior should be teamed with a more experienced student until it has been definitely established that he has conquered the underlying principles. What possible benefit is derived by the student from automatically carrying out specific procedures without complete understanding of the theory behind them? Admittedly there are times, especially during the "balance sheet rush", when the senior, in an endeavour to meet his client's deadline, feels that he does not have the time for such instruction. Often he finds it much easier to give his staff the last year's working papers as a guide in place of a complete verbal explanation. The schedules which result from blindly following the course set out in the working papers may appear attractive and correct on the surface, but such a practice may result in the passing over of pertinent information which materially affects the overall result.

Avoid Monotony

Monotony is the seed of dissatisfaction, frustration, and carelessness. How many juniors, after four or five months of continuous vouching of petty cash disbursements, freight bills, and cancelled cheques, are completely fed up with the whole auditing business and ready to give up entirely? In an endeavour to eliminate monotony and to keep up the students' interest at all times, tasks should be rotated so that no member of the staff will be left on one particular procedure for months on end. Although a student may have become expert in certain procedures, he must not be considered an inseparable assistant in this procedure and be delayed in his progress in other aspects of his training.

It is not necessary to rotate students before they have completely mastered the particular audit procedure assigned to them. At the same time, the student's ambition to learn and to use his own initiative should always be encouraged, and when it becomes evident that

a particular student is ready for more advanced work every effort should be made to provide it. The willingness to accept responsibility can only be inculcated by the progressive allocation of new tasks. In this way the work of supervisors and seniors will also be considerably cut down through the gradual absorption of advanced work and responsibilities by the members of their staff as the latter gain experience. A program of work which makes full use of the abilities and knowledge of each member of a staff will produce, in less time and with less burden to each member, a better result than could possibly be obtained by the allocation of all advanced work to the senior members of the staff.

Miss Gertrude Mulcahy, B.A., C.A. was associated with Clarkson, Gordon & Company, Toronto, for several years and in 1947 was admitted to the Ontario Institute. In 1949 she joined the staff of The Canadian Institute of Chartered Accountants as research assistant.

Alas! Poor Sleuths

Many students become bitter over the task of detecting and correcting errors. Like Sherlock Holmes they press on for days, vouching in all directions, without uncovering any clues of mistakes or omissions, until at last out of the very depths of despair they find one small error, pounce upon it, and proudly bring it to the senior's attention. The senior, who has been nodding behind an open voucher for the past half hour, merely glances at the item and mutters "Forget it, too small." With a never-say-die attitude, the junior returns to his task and on discovering further errors is inclined to say to himself, "Forget it, too small". Until a student has had sufficient experience to be capable of judging the cause and significance of an error, the senior should insist that every irregularity be brought to his attention. In each instance the senior should take time to explain the repercussions of this error in the records and the basis of the auditor's attitude towards it.

A common question among students, especially in the first few years of their training, is the ultimate resting place of the schedules which they prepare and their significance in relation to the financial statements upon which the firm is reporting. On completion of the working schedules, the senior in charge of the particular job files them in his volume of working papers. As far as the student is concerned, that is all he ever sees or hears of them until they are used as a guide to next year's work. The wiser course would be for the senior, on the completion of each balance sheet, to go over the detailed working papers with the members of his staff, tracing each particular schedule to its final place in support of the figures of the financial statements. It is true that the clients are ever clamouring for their statements and that this task would involve considerable time, but never let it be forgotten that in addition to meeting client's needs, the accounting firms owe an obligation to their students. These young men came to their employ to learn, not to work blindly with nothing to show for their efforts but inky fingers and horned rimmed glasses.

Staff Discussions Valuable

In addition to the above suggestions, regular staff discussions of problems arising in the course of audits and in the assigned course of studies are highly commendable. From these each student has the benefit of the experience of the other students and is the better equipped to

meet difficulties or irregularities which arise. During the war, when accounting firms were obliged to employ inexperienced temporary help, series of lectures were given by many of the principals to provide their employees with a comprehensive explanation of their tasks. With the return of the regular students, this practice has been abandoned by many firms, in spite of the excellent results obtained. However, the lectures on the course of studies, which have been undertaken in a few of the Institutes, and the staff training courses conducted by many accounting firms, suggest that there is an awareness of the responsibility and that some attempt is being made to fulfil it.

Perhaps the key to this whole problem lies in the division of the personnel of the accounting firm. Staff should, where possible, be divided into partners, supervisors, seniors, and students. To each a particular responsibility should be assigned. The supervisors and seniors, qualified by training and experience, assume the immediate charge of engagements, plan the program of audit procedure, and actually supervise the work of the students. It is, therefore, imperative that, in the appointment of supervisors and seniors, the accounting firms consider the candidate's ability, not only to meet the client's needs but also to carry out the firm's obligation for the training of students.

Earning Dividends

Time seems to be the element against which the students are competing, and in the race to meet the client's needs the training of juniors is often left far behind. It should be realized that every effort put forth by a firm towards the efficient supervision and education of its staff will ultimately be compensated by the satisfaction of the client's needs in the most efficient manner.

A recent examination paper required a statement of the reason for checking the details of the duplicate deposit slips to the cash book. One candidate's answer was: "To see if cash being deposited today, was received tomorrow". Somewhat altered, this is a useful piece of advice to the accounting firms: "What you deposit today, you will receive tomorrow".

Falsification Of Records

By C. K. MacGillivray, C.A., F.C.I.S.

Recent times have witnessed a sharply rising trend in criminality in general and embezzlement in particular

THE subject of "Falsification of Records" is quite a timely topic because in the last few years there has been a sharply rising trend in criminality in general and in embezzlement in particular. Canadian statistics on the latter crime are not adequate, but the Dominion Bureau of Statistics has supplied me with the annual number of convictions for embezzlement in Canada which show a rise of 232% from 1944 to 1949. Also indicative of the trend are the fidelity losses paid by Dominion licensed insurance companies, which have risen abruptly from 1944 to 1950, being about 14 times larger in the latter year than in the former.

The United States Federal Bureau of Investigation has stated that it was handling nearly one-third more embezzlement cases in 1951 than in 1950, and about two and one-half times the cases of 1946. These figures should serve as a warning that the present trend to dishonesty within business is very serious.

Deterioration in Morality Since War

A survey of pre-war and post-war records of embezzlement cases reveals some interesting changes. Since the war there has been an increase in the number of irresponsible and criminally inclined persons, in the offenders who stole at the first opportunity, in collusion, in the cases caused by liquor, gambling, and domestic troubles, and in the percentage of absconders; there has been a decrease in the average age of the culprits, and those whose remorse led to suicide. Among other things, the facts provide an interesting sidelight on the deterioration in morality between the two eras.

The greater prevalence of defalcations is being accentuated now by the effects of inflation, the present credit restrictions, the high cost of living, and the tightening of the supply of money. As this situation intensifies, we can expect to hear of more and more cases of inside thefts in business. Alert executives should realize that the danger is greater and take the steps necessary to strengthen their accounting systems and to guard against the dishonesty of their employees.

Trust No-one!

Almost everyone has some chinks in his armour of honesty, so that you can never tell who in your own office is liable to slip from "the straight and narrow path". When a veteran of many years of unblemished service purloined

An address to the Hamilton Chapter of N.O.M.A., April 1952

$3,600 from the Continental Illinois National Bank and Trust Company, one of his fellow officials refused to believe it until he personally heard a confession. A judge confessed to stealing $630,000 from a bank for which he was vice-president and legal counsel. In my knowledge and own experience, thefts have been uncovered incriminating well known and highly regarded company officials, leaders in church work, employees with long years of apparently faithful service, and individuals with honest-looking faces. A survey made by one bonding company in 1937, and not altered much by another survey in 1950, indicated that the average male embezzler was 36 years old, had a wife and 2 children, owned a medium priced car, was a good mixer, participated in social and community affairs, had a high school education, and was favourably regarded by his employers. Many people have no better principles than the tramp who was heard to remark, "Honesty is the best policy", after he had stolen a dog and later returned it to claim the reward. Most employers are lulled into a false sense of security because most defalcations are not made public, and they do not know how prevalent the cases are. Recent estimates from bonding companies on this continent indicate that businesses experience about 500 inside theft cases per working day, costing about $1,500,000 per working day or over $400,000,000 per annum.

The subject of the falsification of records may be divided into three main parts:—

The McKesson & Robbins Case

Firstly, falsification to give an untrue picture of the financial position or operations of a business to a bank, creditors, or others. A classic example is the *McKesson & Robbins* case, where the company's president and other officials conspired together and caused untrue entries to be made to record non-existent inventories, accounts receivable, and sales. Faked certificates, letters, invoices and other documents were printed especially for the purpose. The conspirators went so far as to establish an office in Montreal under the name of a supposed supplier, and when the company's auditors requested verification by mail of accounts and inventories, replies were received which seemed satisfactory. Subsequent investigation revealed that irregularities continued for 14 years, and that the company's assets carried on its balance sheet at $89,000,000 had been inflated improperly by $19,000,000.

Secondly, there is falsification to avoid income or other taxes. You have all read about a number of cases of this type in the newspapers recently.

Thirdly, comes falsification by an employee to defraud his employer. This aspect is my main concern in this article.

Protective Procedures

The design of a company's bookeeping system and the allotment of duties to employees should be so planned that the possibilities of defalcation are minimized. Among accountants, this arrangements is known as "internal check" and is considered to be one of the most effective means for the prevention of inside thefts. All duties involving the possibility of fraud should be so divided among the staff that no one member will have access to or control enough records to conceal any sizeable irregularity. For example, subject to the special conditions prevailing in any office, the office manager, treasurer, or auditor should arrange that:—

(1) Cashiers should not open the mail;
(2) Cashiers should have access only to their cash books, but not to the ledgers;
(3) The function of receiving money

should be separated from that of paying out money;

(4) Regular trial balances of the accounts receivable ledgers should be taken off and statements to customers prepared and mailed by other clerks than those who keep each individual ledger;

(5) Cheques should carry more than one signature and be signed only after the production of completed vouchers;

(6) Someone other than the storekeeper should list or examine the stock at inventory taking;

(7) Serial numbers should be used on cheques, invoices, receiving slips, purchase order forms, etc., and the official responsible should be able to account for all numbers at any time. The clerks in charge of the supply of pre-numbered forms and accountable blank documents should have nothing to do with the use of those documents;

(8) Each employee should be taught to perform more than his own job so that duties may be rotated or exchanged — but this exchange should never be effected except on the explicit instructions of the executive officers in charge; and

(9) Office managers, or other responsible officials should be charged independently with the obligation to verify periodically general and petty cash funds, bank reconciliations, the proper balancing of subsidiary ledgers, and the restriction of clerks to their definitely prescribed work.

These and many other rules should be designed for each office individually, should be made clear to the employees, and should be strictly enforced. The responsibility for enforcement is one which is frequently overlooked, or else the first one neglected when other work becomes pressing. In any case, the maintenance of an effective system of cross-check depends upon the alertness and discipline maintained by the office manager and his assistants.

Shortly after being admitted to the Ontario Institute in 1929, Mr. C. K. MacGillivray, C.A., F.C.I.S., began to practise the profession and in 1933 became a partner of the firm of Chagnon & MacGillivray, Chartered Accountants, Hamilton. He is an appointee of the Ontario Institute to the Public Accountants Council of the Province of Ontario.

The double-entry system of bookkeeping nowadays used by almost all businesses gives rise to the principle of charge and discharge. This principle is fundamental in establishing a system of internal check. The idea is that once any asset has been received or acquired by the business, it is charged on the books to its proper account, and supposedly remains in that original form until another entry is made indicating that it has been transferred into another form or satisfactorily expended. If the transferring, or credit, entries are properly authenticated and controlled, and if the existence of the still accountable assets is regularly and adequately verified, then misappropriation of those assets over any lengthy period of time will be prevented.

The regular accounting view may be studied from another angle in a concept which might be called "the personification of charges". Under this concept, in the mind's eye of the comptroller, all asset charges are considered as being debited to particular employees who are definitely responsible for those assets until the records show that the property or responsibility has been passed on satisfactorily to other employees, or to the owners.

Failure to Make Entries

One way an employee may endeavour to avoid accountability for certain of his company's property is by failing to make any entry whatsoever for it. A clerk may pocket the proceeds of a cash sale, or a stockkeeper might take home some newly purchased tools without making an entry for them on his receiving record. A certain amount of cash sale trouble can be eliminated by the use of cash registers and strict rules for their operation, by an adequate system for checking in-going or out-coming goods or cash, or by providing a clear-vision layout of office or storeroom. Sometimes it can be located by employing one of those organizations which make a specialty of acting as testers or watchers and whose operators pretend to be ordinary customers or otherwise, one of their tricks being to put temptation in the way of clerks and to watch the result. Often, an executive or auditor may ferret out a leak by watching for abnormal percentages of gross profits, costs, or certain classes of expense. Nevertheless, failure to record assets in the first instance is one of the most difficult of all irregularities to track down.

False Entries

There are probably half a hundred distinctly different ways that misguided employees have used to make false entries to victimize their employers. I shall describe some of the more common methods:—

(1) A clerk may pay bills to non-existent persons or companies, and arrange to cash the cheques. Often this involves preparing fictitious invoices, receiving slips, and other supporting documents.

(2) He may raise the amounts on cheques, invoices, or other vouchers after they have been approved by responsible officials. You all know how easy it is to insert digits in front of figures already authenticated on documents and in books.

(3) He may issue credit vouchers or payment for "phony" customers' claims, or for returned goods which were, in fact, not returned.

(4) He may collect doubtful accounts receivable but report them uncollectible and write off the accounts; or he may make collections on accounts previously written off and not re-instate them on the books.

(5) He may insert fictitious names on a payroll or pad time on production records, so that the payroll total shown will be in excess of that actually payable. Of course he pockets the difference.

(6) Erroneous footings of cash items, sales, or other lists can be used to create false credits, against which improper drawings of funds may be made. Very few people enjoy re-adding long columns of figures already footed by someone else, and there is a very strong tendency to accept the apparently sincere total of an adding machine tape as beyond suspicion — particularly if the records appear in balance.

(7) Lapping the cash is a favourite method. A cashier may receive collections on Monday and Tuesday, which he does not enter because he misappropriates the funds. Collections on Wednesday and Thursday are entered, but recorded as those of the remitters of Monday's and Tuesday's funds. Thus the cashier probably can retain cash without his office associates or the customers noticing anything unusual.

(8) The kiting of cheques or cash orders is often used to conceal discrepancies in cash balances.

(9) Forging cheques, altering cash book entries and returned cheques to cover, and removing the forged items before audit, is a scheme sometimes tried.

(10) It is often possible to use the same approved voucher twice, or a duplicate copy of a good voucher, to cover an improper disbursement. By simply changing one figure in the year date, last year's voucher may be made to look presentable this year.

(11) Understating the amount of goods shipped out and splitting the resulting gain with the consignee is another scheme.

(12) Goods or supplies controlled by perpetual inventory records may be spirited away with the fact being covered by false or raised requisition slips, unauthorized inventory adjustment entries, or the like.

The Case of Mr. Wilby

An instance of an interesting defalcation is the case of Ralph M. Wilby, of Hamilton, Ontario, who was an expert at the job of embezzling but who was tripped up eventually each time. His last attempt was his most successful and it makes a most intriguing story. Here are some of the salient features.

Wilby started out on his most recent adventure by advertising that he was an employer in search of a highy qualified accountant. From one of the applicants, he obtained copies of letters of recommendation and references, which he then presented in New York using the name of the applicant as his own, and obtained a position there with William T. Knott Company. This is a management corporation which manages 16 department stores in the United States and The Right House in Hamilton. Among other things it pays for the merchandise which these stores buy. The department stores check the invoices which are then sent to the Knott Company and checked against purchase orders there. An intricate machine bookkeeping and tabulating system has been evolved to handle the mass of invoices, allocate the charges, and summarize and add the results. At the end of the process is a cheque-signing machine surrounded by precautions and secret adjustments which makes the system foolproof. Nevertheless, Wilby found a way to beat it. In 1942 he stole $110,936.81 and in 1943 $275,984.48, at the same time impressing his office associates with his accounting knowledge, efficiency, and personality. Indeed he was paid a bonus in both years. To accomplish his defalcations he created fictitious businesses in surrounding cities, rented desk or small office space for each one, and opened bank accounts for them. Then he had fake invoices printed for these companies, filled in with non-existent merchandise and made to appear verified and approved, whereupon he inserted them from time to time among the regular invoices awaiting payment. As Friday was the peak period for sending out cheques, Wilby arranged that most of his invoices were included in the Friday batches. Whenever possible, he removed his completed cheques prior to mailing. In any case, they all found their way into the bank accounts of his companies and later into accounts in his own name. To conceal any noticeable deficiencies resulting from these large withdrawals, he studied the operating percentage results and ratio of expenses for each store and distributed the charges so deftly that no distortion appeared and no suspicions were aroused. His technique in this and other phases of his plan was impeccable. After the annual balance sheet audit, he contrived to remove and destroy all the false records.

A Strange Coincidence

Wilby might have kept this process up almost indefinitely if he had not been frightened into disappearing by a strange coincidence. In one of his ethereal businesses he had used the name Frederick B. Hecht and this German

name attracted the attention of the F.B.I. which noticed it while perusing the records of a St. Louis bank in search of aliens. No one seemed to know anything about Hecht until the bank manager suggested that an F.B.I. operative enquire at the Knott Company, as it had issued him some cheques. This operative inquired of Wilby who said he knew Hecht, that he was a reliable jobber and then Wilby produced more fictitious invoices to support his remarks.

In December 1943, an F.B.I. man came back to him with further inquiries. Wilby gave him false clues; but the G-men were now highly suspicious that Hecht was a German agent, and Wilby saw he was eventually heading for a show down. In January he withdrew from the banks his ill-gotten $387,000 and quietly disappeared into Canada.

The circumstances surrounding his tracing, capture, extradition, and trial, read like an exciting detective story.

Some Suggested Precautions

What precautions can an office manager or executive take to minimize the risk of embezzlement? Here are a few general suggestions.

(a) Be sure you have a competent firm of accountants as your external auditors. Consult them about your accounting system, and take their advice on changes and the amount of auditing that is desirable. It may be cheaper in the long run.

(b) Bond liberally all employees in a position of trust where fraud is possible — even if you think them absolutely honest. Many fidelity claims are paid every day on culprits who were indicated to be honest citizens by their bosses' convictions and the rigid character investigations of the insurance companies. Statistics show that only 10% of fraud losses are covered by insurance, whereas 76% of fire losses are covered. Moreover, a study of 1000 embezzlement cases which were covered by insurance revealed that the total losses were insured to the extent of only 56%.

(c) Make full use of an adequate system of internal check. In larger companies, create an internal audit staff as well.

(d) Make complete investigations of all prospective employees proposed for placement in positions of trsut. Know your employees well, and keep studying them. Try to find the reason for any basic change in their approach to their work, or excessive spending. It is important also that the owners or management maintain cordial relations with the staff because an antagonistic frame of mind is more likely to induce stealing on their part.

(e) Insist on employees taking vacations regularly, and study any peculiarities in their work which substitutes may notice.

(f) Usually it is desirable to have your auditors send verification notices to customers or others, at least once a year.

(g) The periodic balancing of all books and controlling accounts should be kept right up to date. The warning sign should be recognized if a cashier, bookkeeper, or stockkeeper persistently fails to maintain his records in balance or to keep his bookkeeping current.

(h) Finally don't explain to any employee the checks that are being made to them, or what loopholes in the system may exist. As Shakespeare said, "How oft the sight of means to do ill deeds, makes ill deeds done."

A Method of Replacement Accounting

By Peter Bakker

A useful contribution to a subject of growing interest and importance

A. Basis for Replacement Accounting

ACCORDING to the replacement theory *profit* is the favourable difference between *net proceeds* and the *values sacrificed* in the business process in order to obtain these proceeds. The values sacrificed are represented, not by the original purchase prices, but by the cost to be paid for the *replacement* of the values transferred.

In order to preserve the capital entrusted to the business by its proprietors at its original value (not in monetary terms but in terms of equipment, goods and such), necessary for the financial safeguarding of the business, the replacement of the values sacrificed in the operating process, ought to be synchronized with the consumption.

This necessity for replacement only applies to a going concern, not for isolated transactions such as speculation (in goods, shares, currency, etc.) and the liquidation of a business.

B. Principles and Conventions for Replacement Accounting

The application of the replacement theory in private enterprises for the purpose of establishing a basis for pricing, as well as for the purpose of profit-control and capital preservation, requires:

(a) the cost system be operated in such a way that changes in the replacement costs of the products and services are reflected in the cost data with a frequency, accuracy, and speed as required by the relative importance of these changes with respect to managerial decisions;

(b) the accounts show the profit made, based on the replacement costs of the values sacrificed;

(c) the accounts show to what extent the capital is preserved at its original value.

These requirements can be effected in many ways dependent on the size of the business, the nature of its operations, the variety of operations as well as of the variety of the products and services manufactured and sold.

Essentials for each system are:

(a) that for managerial decisions, viz., (for pricing purposes and for profit control) the replacement costs can be determined quickly when required by circumstances;

(b) that the "cost of sales" is entered into the accounts at replacement costs;

(c) that the assets and liabilities accounts as well as the capital accounts permanently are kept at replacement value;

(d) that the cost of operating the cost and the accounting systems is kept within the limits of its advantages.

C. Practical Approach

Experience obtained from experiments and practical use has proved that replacement accounting for nearly all purposes can be best operated on the basis of standard costs. The standard costs, once being properly established, are an excellent basis against which all the price fluctuations can be measured, not only of each cost element against its standard but also of the effect that each cost element has on the total standard costs of a product.

By a careful segregation of the actual costs into costs at standard prices on one hand and price fluctuations on the other hand, the application of the standard cost system as a means for efficiency control in the accounting procedure can be maintained. This is a great advantage, in particular in companies with complicated operations or a great variety of products, where a frequent revision of standard costs is impossible.

The eliminated price fluctuations can thus be measured against the standard costs and provide the information for revision of product unit costs for the purposes of pricing, profit-control, and for profit determination.

By allocation and proration of these price fluctuations to the different products (or operations) according to the same principles and conventions applied in the establishment of the standard costs per product unit (or service unit) the total price fluctuation per unit is determined. This system is useful in companies where the variety of operations and products is not too great.

For companies with a greater variety of operations and products, in particular in manufacturing, however, the above-mentioned system may prove to function too slowly or too expensively when compared with the results.

These companies should use an index number system based on the price fluctuations of only one article or service, representing a group of similar products or services. The number of similar groups (similar with respect to price fluctuations) determines the number of index numbers to be calculated. In order to increase the speed in the production of index numbers, in particular in periods with sharp fluctuations, the actual price fluctuations shown by the accounts should not be taken as a basis, but rather the price fluctuations according to price quotations, and in some cases where a price increase or decrease is expected in the near future, the estimated fluctuation should be taken.

This procedure appears to be flexible to a very great extent, in particular where management desires to be informed quickly and with up-to-date information as a basis for decisions.

By a sound profit determination in the accounts (on the basis of replacement costs of the values sacrificed) the capital invested in assets of a material nature, viz., fixed assets and stocks, is automatically kept at its original value, except for capital losses, e.g. in the case of fire when under-insured. This means that a replacement accounting of the capital invested, on a daily basis, is not necessary. A periodical review of the accounts concerned, on the basis of the information available through replacement cost data, is sufficient.

Of an entirely different nature, how-

ever, is the problem of the replacement value of that part of the capital, entrusted to the company by its proprietors, that is invested in monetary assets, such as cash on hand, accounts receivable, etc. The only possible safeguarding against depreciation of this part of the capital is to take care that the monetary assets of the company permanently equal the monetary liabilities, or, in other words, to utilize the capital of the proprietors only for material assets.

In periods of rising prices where a company has a part of its own capital invested in monetary assets and a loss results, this loss should be taken into account in the determination of the net profit earned.

In the following paragraphs some remarks of a more technical nature in the replacement accounting, illustrated by charts and some examples, will be made.

D. Replacement Accounting in Merchandising Business (Chart Ia)

The price variances on purchases are eliminated and entered into a separate account "Price Variance Account". The stocks on hand are kept at standard prices.

"Cost of Sales" is periodically charged through the normal procedure with the standard cost of sales.

Periodically (daily, weekly, monthly, as the necessity arises) the difference between standard costs and replacement costs, through a product unit calculation or an index number for the entire product group, is established. In the case of higher replacement costs, as shown in example *Ia*, "Cost of Sales" is charged and "Price Variance Account" is credited for the price variance absorbed (*see p.* 66)

When the standard price is revised (in example *Ia* to the level of replacement cost in June) the amount of the revision is transferred to "Surplus Account".

Mr. Peter Bakker recently arrived in Canada from Eindhoven, Holland. From 1929 to 1952 he was associated with Philips Industries Limited in Eindhoven as chief accountant in charge of the Concern Budgeting Department and later as Secretary to the Central Budget Committee. He is now treasurer of Philips Industries Limited, Toronto.

From chart *Ia* and the figures shown herein as an example, it appears that the capital available (only with respect to stocks) by application of replacement accounting is permanently equal to the amount of the stocks, whereas to profit available for payment to the proprietors, only the difference between net proceeds and replacement cost of sales will be shown in the accounts.

The "Price Variance Account" will balance if the following conditions are fulfilled:

(a) No errors are made in the establishment of the replacement costs.

(b) When sales and replacement of goods sold are synchronized, in other words, when stocks are permanently kept on the same level.

In the establishment of the replacement costs, in particular by means of index numbers per product group, differences of minor importance between the actual replacement costs and the calculated (or estimated) replacement may arise which are left as a balance in the "Price Variance Account". When the quantity of stock on hand at the beginning of the period equals the stock on hand at the end of the period, a balance in the "Price Variance Account" is to be transferred to the profit and loss account (or "Cost of Sales").

E. Replacement Accounting in Case of Unsynchronized Replacement

What happens when stocks fall below the normal level or, in other words, when replacement of the goods sold is delayed, is shown in chart *Ib* (*see p.* 67).

In periods of rising prices a delay in the replacement will lead to a loss, in periods of falling prices to a profit. It is the purpose of replacement accounting to separate profits and losses as a result of the normal operations being the primary objective of the company, from profits and losses due to speculation in prices or profit and losses owing to other considerations than planned for normal operations. How this is effected is shown in chart *Ib*.

F. Replacement Accounting in Manufacturing Business

The basic principles for replacement accounting in manufacturing are the same as in the simplest merchandising business. The work involved in setting the replacement costs and in accounting may be greater or more complicated. This does not change the basic principles.

As shown in chart *II* the price variances, measured against the cost at a standard basis, are eliminated at the time of payment and entered in as many variation accounts as may be considered useful for the purpose of accounting.

The total amount of variances is by means of separate rates, index numbers and such, applied to the standard costs of sales, transferred to the "Cost of Sales" account.

The revision of the standard prices at which the inventory accounts are kept is transferred to the "Surplus Account" as well as the standard price revision on the "stock deficit", if any, in order to bring up the capital account to the level needed for continuation of the business at the normal level.

The greatest difficulty in replacement accounting met in a company which manufactures a great variety of products is the setting of index numbers. A direct allocation of the various price variations to the different products is as difficult and time-absorbing as a direct allocation of the costs themselves. Everybody familiar with the problem of cost allocation, in particular the overhead through cost centres and production centres by means of allocation and proration of the costs or by means of rates, has an idea what amount of work and time would be involved when the same procedure had to be followed on a weekly or monthly basis.

Assuming that speed in the production of figures is preferred to high accuracy, the following system may be recommended. The various products are grouped into similar product groups, similar with respect to the nature of the products, their composition (with regard to material, labour and overheads), and similar with respect to their sensibility to price fluctuations. As a rule this is easier than it seems to be because many companies, having a great variety of products, will find that in each group a few models are predominant or standard and the other models slightly different from the standard model in size, colour, etc. in order to suit a specific customer's demand.

For the purpose of setting index numbers, the product(s) being representative for the entire product group is chosen. Those representative products of the various product groups have to be broken down into the basic cost items, such as direct material to similar material (e.g. iron, copper,

zinc, wood, cotton, wool, etc.), direct labour also (e.g. skilled labour in classes, unskilled labour, etc.), overhead into expense classifications, such as salaries, indirect wages, social welfare expenses, depreciation buildings and equipment, steam, gas, water, electricity, postage, telephone, etc.

Statistical returns, to be kept daily up-to-date, e.g. on the basis of price quotations at material markets, of suppliers, etc., provide the information for a frequent and quick re-pricing of the basic cost items of the various representative products.

The total cost of each representative product, expressed in a percentage of its standard costs, is the index number that applies to the entire product group to which the representative product belongs.

These index numbers serve management in reviewing sales prices for profit control; they serve the accounting department by establishing a profit and loss account on a replacement value basis and by the periodical revision of the value of assets and capital, and, when needed, by drawing up a balance sheet on a replacement value basis.

The total variance absorbed in the cost of sales may slightly differ from the total actual variances. Except in cases where the replacement of the stocks on hand is not synchronized with the consumption, these differences should stay within acceptable limits. Great differences indicate errors in the setting of index numbers or the accounts. Entering the variances as well as the absorption of the variance in the accounts provides a means of control of the index number calculations.

G. Replacement Accounting for Fixed Assets

In chart *III* (*see p.* 69) we see how replacement accounting can be effected for buildings, machinery and equipment, which are subject to price changes.

This part of replacement accounting follows the same basic principles as for stocks of goods.

In the application of the replacement theory on fixed assets, however, the dangerous effect of rising prices with respect to the original value of the capital invested in the company is hidden in the depreciation.

The yearly (monthly) amount of depreciation is based on the prices of equipment in effect at the time the depreciation is calculated and recovered in the sales prices. By doing so in times of steadily rising prices it appears that at the moment that replacement of the equipment has to be effected, the cash amount, representing the recoverage of the depreciation absorbed during previous years in sales prices, is far less than the amount needed for replacement.

Basically this is due to the fact that contrary to stocks of goods, replacement is postponed. Only companies with a great amount and variety of fixed assets, harmoniously composed with respect to ages, which are in a position to replace yearly the same amount that is consumed (as depreciation absorbed in sales prices), can prevent this undesirable situation. Other companies have to take a loss in order to preserve their capital at its original value and in order to have the necessary cash on hand as soon as replacement is wanted.

IA — Process Chart Replacement Accounting Merchandise (When stocks on hand are maintained at a normal level)

Stocks at Standard Price

Jan. 1st	$100,000	Sold	
Purchases		Jan.	$ 25,000
Jan.	25,000	Feb.	$ 25,000
Feb.	25,000	March	$ 25,000
March	25,000	April	$ 25,000
April	25,000	May	$ 25,000
May	25,000	June	$ 25,000
June	25,000	Balance as per 30th June	$112,000
Revision st. pr. to surplus acct.	12,000		
	$262,000		$262,000

Accounts Payable

Price Variance Account

Purchases		Absorbed	
Jan.	$ 500	Jan.(102)	$ 500
Feb.	1,000	Feb.(104)	1,000
March	1,500	March(106)	1,500
April	2,000	April(108)	2,000
May	2,500	May(110)	2,500
June	3,000	June(112)	3,000
	$10,500		$10,500

Cost of Sales (at replacement costs)

	$ 25,000		
	25,000		
	25,000		
	25,000		
	25,000		
	25,000		
	500		
	1,000		
	1,500		
	2,000		
	2,500		
	3,000		
	$160,500		

Capital Account

		Jan. 1st	$100,000

Revaluation Account

		June 30th	$ 12,000

Profit and Loss Account (This Period)

IB — Process Chart Replacement Accounting Merchandise (when stocks on hand fall below a normal level)

IB — PROCESS CHART REPLACEMENT ACCOUNTING MERCHANDISE (when stocks on hand fall below a normal level)

Stocks at Standard Price

Jan. 1	$100,000	Sold	
Purchases		Jan.	$ 25,000
Jan.	15,000	Feb.	25,000
Feb.	15,000	March	25,000
March	15,000	April	25,000
April	15,000	May	25,000
May	15,000	June	25,000
June	15,000	Balance as per 30th June	44,800
Revision st. pr. to surplus acct. (1)	4,800		
	$194,800		$194,800

Price Variance Account

Purchases		Absorbed	
Jan.	300	Jan.	500
Feb.	600	Feb.	1,000
March	900	March	1,500
April	1,200	April	2,000
May	1,500	May	2,500
June	1,800	June	3,000
Transfer to surplus acct. (2)	7,200	Transfers to P/L acct. (3)	3,000
	$13,500		$13,500

Cost of sales (at replacement costs)

	$ 25,000		
	25,000		
	25,000		
	25,000		
	25,000		
	25,000		
	500		
	1,000		
	1,500		
	2,000		
	2,500		
	3,000		
	$160,500		

Capital Account

		Jan. 1	$100,000

Revaluation Account

		30 June	$ 4,800
			7,200
			$ 12,000

Profit and Loss Account (This Period))

Loss due to arrears in replacement	$ 3,000		

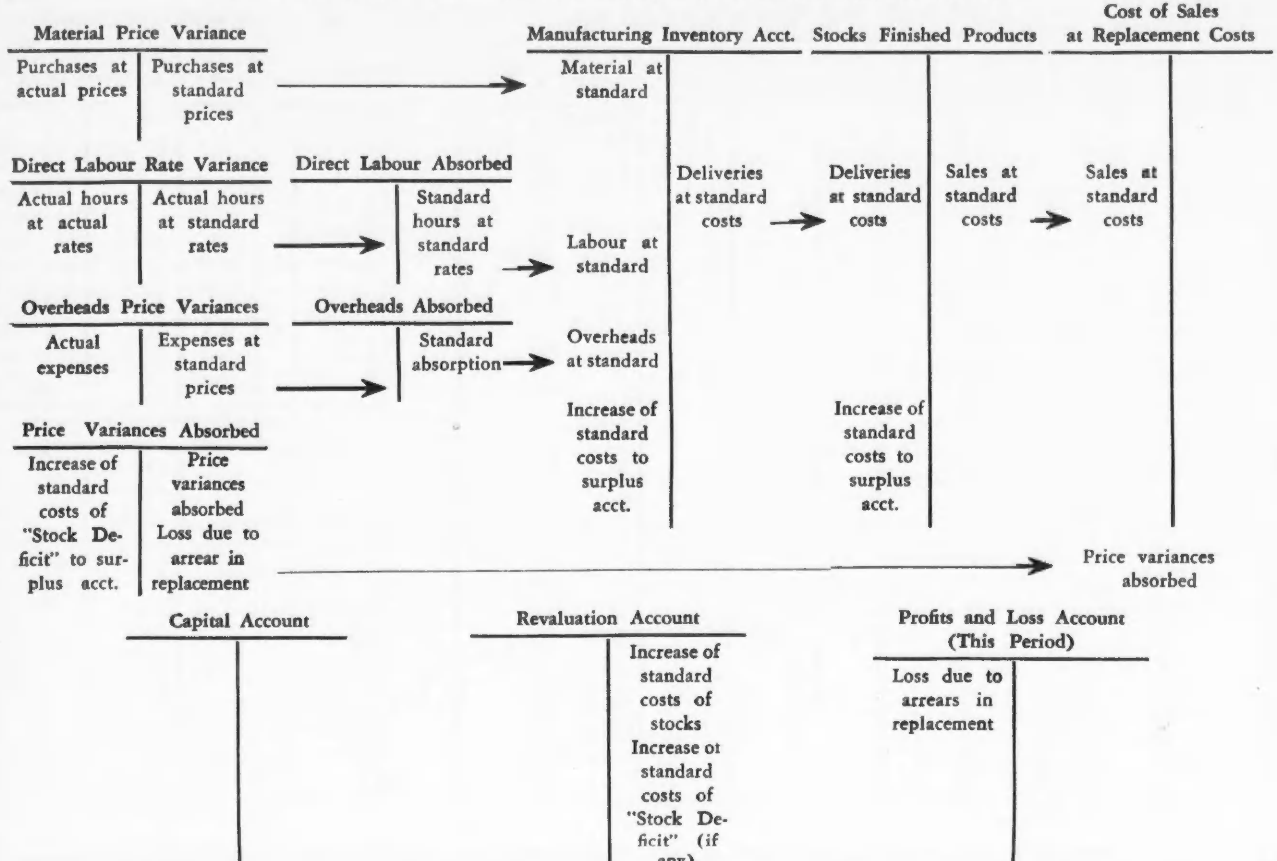
(1) The replacement value as per 30th June at which the new standard prices for the next period are set* is 12% above the old standard price. Stock on hand as per 30th June, at old standard prices, amounts to $40,000. The replacement value is thus $44,800.

* In this example

(2) The stock on hand is $60,000 below normal level. If this shortage was replaced at the end of June this would cost the firm 12% of $60,000 extra above the amount available, thus $7,200.

(3) Because stock is not duly replaced in time the company suffers a *loss* of $3,000.

II — PROCESS CHART REPLACEMENT ACCOUNTING MANUFACTURING AND SALES



III — PROCESS CHART REPLACEMENT ACCOUNTING FIXED ASSETS (Delayed replacement)

ficit" (if any)

III — Process Chart Replacement Accounting Fixed Assets (Delayed replacement)

Fixed Assets

Jan. 1	$1,200,000		
June 30th Revaluation at 106	72,000		

Depreciation (10% annually)

		Jan. 1 (20%)	$240,000
		Jan. (101)	10,100
		Feb. (102)	10,200
		Mar. (103)	10,300
		Apr. (104)	10,400
		May (105)	10,500
		June (106)	10,600
			302,100
		Revaluation to 25% of $1,272,000	15,900
			$318,000

Expense Account

	$ 10,100		
	10,200		
	10,300		
	10,400		
	10,500		
	10,600		

Capital Account

		Jan. 1	$1,200,000

Revaluation Account

		June 30	$ 72,000

Cash on Hand

Jan. 1	$240,000		
Jan./June Dep'n. absorbed	62,100		
Revalua'n	15,900		

Profit and Loss Account (This Period)

June 30 Loss on dep'n. absorbed until 30th June	$ 15,900		

Professional Notes

ALBERTA

Christenson, Simonton & Co., Chartered Accountants, Calgary, announce the admission to partnership of Mr. V. C. Morrison, C.A. They also announce the removal of their offices to 901 8th Ave. W., Calgary

Kinnaird, Aylen & Co., Chartered Accountants, 218 Tegler Bldg., Edmonton, announce the admission to partnership of Mr. Donald L. Brandell, B.Com., C.A.

Clarke & Gordon-Cooper, Chartered Accountants, announce the removal of their offices to 204 Wilson Electric Bldg., Calgary.

BRITISH COLUMBIA

Mr. Tyrus R. Cobb, C.A., announces the opening of an office for the practice of his profession at 2695 W. Broadway, Vancouver.

Crehan, Meredith & Co., Chartered Accountants, and Bruce & Baldwin, Chartered Accountants, announce the amalgamation of their firms. Henceforth practice of the profession will be conducted under the firm name of Meredith, Bruce, Baldwin & Kitto, Chartered Accountants, with offices at 402 W. Pender St., Vancouver, and at Nelson, B.C.

NEW BRUNSWICK

New Brunswick Students Society

Moncton Branch

The Moncton Branch of the New Brunswick Students Society held its final meeting and elections on May 30 at the Beaver Curling Club. The guest speaker was Erskine Mowatt, C.A., president of the New Brunswick Institute. He spoke on "Management Consulting". The following officers were elected for the coming year: *president,* Robert Durward; *secretary-treasurer,* Rolph B. Noble; *executive committee,* Douglas Fraser, David C. Macdonald, George Steeves.

NEWFOUNDLAND

Peat, Marwick, Mitchell & Co., Chartered Accountants, and Howard J. McDougall & Co., Chartered Accountants, announce that their practices have been combined and will be carried on under the firm name of Peat, Marwick, Mitchell & Co. with offices at 344 Duckworth St., St. John's. Mr. Howard J. McDougall, C.A. has become a partner of Peat, Marwick, Mitchell & Co.

ONTARIO

Hilborn & Co., Chartered Accountants, announce the removal of their offices to 219 Bay St., Toronto.

Ontario Students' Association

The Students' Association of the Institute of Chartered Accountants of Ontario held its annual meeting and stag at the 48th Highlanders Memorial Hall in Toronto on May 27. Representatives of the Hamilton, Kingston, and London branches were among the 100 present. The Council for 1952-53 was elected, as follows: F. Warren Hurst, *president;* G. Douglas McLeod, *vice-president;* Richard V. Howson, *secretary;* Ross H. Cutmore, *treasurer;* Alan G. Bowers, C.A.; W. R. N. Campbell; D. S. Cowan; R. J. Duberry; Wm. J. Morgan; P. Stewart, C.A.

The Association held its annual sports day on June 19 with golf at The Elms Golf and Country Club, Weston, and tennis at The Toronto Lawn Tennis Club.

The baseball league got off to a good start on May 12 with 14 teams entered. John McClelland (McDonald, Currie) is the convenor.

QUEBEC

Mr. Harold Alper, C.A. announces the removal of his office to Rm. 24, 207 Craig St. W., Montreal.

The Institute of Chartered Accountants of Quebec

Quebec City Committee

On Saturday June 14, the annual meeting of the chartered accountants of the City of Quebec was held at Manoir St. Castin and the following directors were elected: Maurice DeCoster, *president;* Raymond Fortier, *vice-president;* Roger-H. Stanton, *secretary-treasurer;* Gérard Larose, P. André Lachance, Paul R. Thivierge, Pierre LeBoeuf, and Marius Laliberté, *past president.* Mr. Roland Boilard was named auditor.

The meeting was followed by a dinner for the members and their wives and the following students who had successfully passed their exams and had been admitted as members of the Institute were introduced: Roland Boilard, Charles Chouinard, Paul Gingras, J. Robert Lacroix, Paul-Emile Langlois, Jacques Laliberté, Gérard Lauzier, Emilien Martel, Réjean Moreau, Bernard Proulx, Louis Rochette, Guy Trottier and Jacques Vien.

Mr. J. A. de Lalanne, president of the Quebec Institute, was guest speaker. He pointed out the real interest of the Institute towards the Quebec Committee and invited the members and their wives to take part in all the activities of the annual meeting of the C.I.C.A. which will take place in Quebec and Montreal next September.

News of Our Members

Mr. W. Harold Rea, C.A. (Ont.), has been elected to the Board of Trustees of the National Sanitarium Association.

* * *

Mr. I. E. Laws, C.A. (N.B.), has been elected vice-president of the Society of Industrial and Cost Accountants of New Brunswick.

* * *

A number of chartered accountants are serving on the new executive of the Toronto Chapter of the Institute of Internal Auditors, including: *president,* John A. Edds, C.A. (Ont.); *vice-president,* C. R. Jolly, C.A.; (Ont.); *secretary,* V. H. Smith, C.A. (Ont.); *treasurer,* A. E. Stead, C.A. (Ont.). Messrs. E. Paterson, C.A. (Ont.), J. F. Kidner, C.A. (Ont.), and H. G. Hinton, C.A. (Ont.) were named governors of the Institute.

Obituary

John Graham

The Institute of Chartered Accountants of British Columbia announces with deep regret the death of John Graham, age 76, in New Westminster.

Mr. Graham was born in Scotland and came about 40 years ago to British Columbia. He was admitted to the British Columbia Institute in 1921 and practised his profession for many years, retiring in 1945.

To his widow and children the Institute offers sincere sympathy in their bereavement.

Annual Meetings of the Institutes

ELECTION OF OFFICERS

Alberta

The annual meeting of the Institute of Chartered Accountants of Alberta was held on June 20, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: J. M. Tweddle

Vice-Presidents: Eric Connelly, A. J. Hamilton

Secretary-Treasurer: A. D. McTavish

Members of Council: J. M. Tweddle, A. G. Burton, Eric Connelly, A. J. Hamilton, W. H. Nield, J. L. Kergan, A. D. McTavish, J. B. McClary, C. A. Richards

Representatives on C.I.C.A. Council: A. G. Burton, J. M. Tweddle, Eric Connelly

British Columbia

The annual meeting of the Institute of Chartered Accountants of British Columbia was held on June 23, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: J. L. Helliwell

Vice-President: G. F. Dunn

Secretary-Treasurer: H. Norman Lunn

Members of Council: G. O. Cumpston, G. F. Dunn, M. C. French, E. M. Gunderson, J. L. Helliwell, D. R. Lukin Johnston, J. R. A. Kinninmont, W. F. Martin, J. E. McIntosh, L. W. Smith, F. E. Walden, W. L. C. Wallace

Representatives on C.I.C.A. Council: G. F. Dunn, D. R. Lukin Johnston, W. F. Martin

Manitoba

The annual meeting of the Institute of Chartered Accountants of Manitoba was held on June 24, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: William Young

Vice-President: Daniel Sprague

Secretary-Treasurer: J. A. T. Shelton

Members of Council: J. W. Abbott, W. Aitken, D. J. Campbell, C. E. G. Earl, W. H. Gray, S. B. Laing, C. W. Lynde, W. J. Macdonald, T. D. Poyntz, D. Sprague, W. D. M. Stewart, J. S. Swinden

Representatives on C.I.C.A. Council: William Young, Daniel Sprague, S. B. Laing

New Brunswick

The annual meeting of the New Brunswick Institute of Chartered Accountants was held on June 20, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: G. A. Oulton

Vice-President: I. E. Laws

Secretary-Treasurer: R. Park

Members of Council: F. P. Blackmore, W. W. B. Dick, G. W. Hudson, I. E. Laws, J. A. Marven, E. A. Mowatt, J. O'Neill, G. A. Oulton, R. Park

Representatives on C.I.C.A. Council: G. A. Oulton, I. E. Laws

Newfoundland

The annual meeting of the Institute of Chartered Accountants of Newfoundland was held on June 27, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: R. B. Moyse
Vice-President: J. Hyslop
Secretary-Treasurer: J. C. Newland
Members of Council: G. W. D. Allen, H. R. Brookes, A. C. L. Hudson, S. N. Inkpen, R. Leith, R. B. Moyse, J. C. Newland, J. Hyslop
Representatives on C.I.C.A. Council: R. B. Moyse and J. Hyslop.

Nova Scotia

The annual meeting of the Institute of Chartered Accountants of Nova Scotia was held on June 20, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: J. G. Vickery
Vice-President: C. W. Gurnham
Secretary: D. F. C. Burton
Treasurer: R. C. Buchanan
Members of Council: A. I. Barrow, H. E. Crosby, H. R. Doane, F. A. Nightingale, L. E. Peverill, H. E. Spencer, H. H. Veno, G. A. Finlay
Representatives on C.I.C.A. Council: J. G. Vickery, C. W. Gurnham

Ontario

The annual meeting of the Institute of Chartered Accountants of Ontario was held on June 26, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: B. A. Armstrong
Vice-Presidents: W. L. McDonald, D. A. Ampleford
Secretary: W. M. Brace
Treasurer: J. R. M. Wilson
Members of Council: B. A. Armstrong, W. L. McDonald, D. A. Ampleford. W. M. Brace, J. R. M. Wilson, G. W. Benson, M. A. Bradshaw, J. G. Brown, R. B. Dale-Harris, J. W. Glendinning, H. R. Macdonald, C. K. MacGillivray, W. T. Millard, G. H. Spence, J. A. Wilson
Representatives on C.I.C.A. Council: B. A. Armstrong, W. L. McDonald, D. A. Ampleford

Prince Edward Island

The annual meeting of the Institute of Chartered Accountants of Prince Edward Island was held on June 19, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: E. P. MacPherson
Vice-President: P. A. Lawrence
Secretary-Treasurer: J. W. Dixon
Members of Council: E. P. MacPherson, P. A. Lawrence, J. W. Dixon, R. W. Manning, J. R. Leard, W. E. Massey, W. G. Thompson, T. E. Hickey
Representatives on C.I.C.A. Council: E. P. MacPherson, P. A. Lawrence

Quebec

The annual meeting of the Institute of Chartered Accountants of Quebec was held on June 12, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: J. A. deLalanne

First Vice-President: Rosaire Courtois

Second Vice-President: J. G. Hutchison

Honorary Secretary-Treasurer: J. C. Thompson

Immediate Past-President: G. M. Hawthorn

Members of Council: Henri L. Belanger, Jacques Belanger, R. C. Berry, Malcolm Blakeley, A. W. Gilmour, U. E. Houghland, R. H. Stanton, Sidney Schwartz, Lucien D. Viau, G. S. B. Wickes

Representatives on C.I.C.A. Council: G. M. Hawthorn, J. A. deLalanne, Rosaire Courtois

Saskatchewan

The annual meeting of the Institute of Chartered Accountants of Saskatchewan was held on June 21, 1952.

The following officers and members of Council were elected for the year 1952-53:

President: H. Austin Hunt

Vice-President: R. L. Bamford

Secretary-Treasurer: Thos. H. Moffet

Members of Council: R. L. Bamford, W. H. Cook, L. E. Fingarson, Ian Forbes, Reginald Hodsman, H. A. Hunt, S. O. McMillan, H. S. Moffet, S. A. Wik

Representatives on C.I.C.A. Council: R. L. Bamford, H. A. Hunt, H. S. Moffet

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

WE ARE becoming more and more convinced that the process of changing accounting terminology is a mighty slow one, and this even when there seems to be general agreement that the current use of certain terms (in particular the word "reserve") is not satisfactory. Recommendations for improvement in terminology are made, resolutions are passed, and bulletins are issued, but financial statements prepared for publication do not seem to have been influenced very much by them.

Text books are written and accounting lessons are given which teach a careful use of terms and presentation of data, but the student soon learns that those who prepare financial statements in practice often disregard these rules. The whole subject is therefore branded as "academic" and what could be worse? Indeed, the all too obvious suggestion is that the text book or teacher was wrong.

In a rising crescendo of indignation we say it is no justification for a given method of presenting or describing data on financial statements to point to what happens in fact. The fact that a certain presentation of accounts appeared in *published* financial statements certainly does not mean it is above reproach. Need we point out that many things appear in print that are thoroughly bad (just as many things in print are extremely good)? We are being naive indeed if we think a thing is praiseworthy because somebody published it.[1] Many thinking people have deplored the "air of authority" and the "halo of precision" which envelops the printed word.

* * * *

We would like now to quote from an article dealing with possible changes in accounting terminology, and then to reveal something of interest about the article:

"Yet there is a word in ordinary speech which suggests exactly the idea which an accountant has in mind when he sets up a 'reserve for depreciation'. It is used in business and other walks of life in exactly the sense that it is used by some accountants, namely the word 'allowance'. . . . It is difficult to believe if the word 'allowance' were always used for the title of accounts intended to show overvaluations that confusion in the mind of the layman would be so prevalent as today it is, and that any new misconceptions could be created by such adoption. . . . There is also the need for a term to represent that which neither is an overvaluation of present assets nor a reservation of past profits. The best illustration of this is provision for income taxes to be levied on the income of one period and paid in a subsequent period . . . Again we ought to use a word which falls within the speech of the layman. We commonly say we have 'provided' for certain things."

The same author goes on to suggest that the description "Estimated liability for income taxes" would be equally as good as "Provision for income taxes" among the current liabilities on a bal-

[1] Hoist by our own petard, we are obliged to admit that what we have said applies also to The Students' Department.

ance sheet. In any case either is better than "reserve for income taxes".

While we do not care particularly for the author's suggestion that allowance for depreciation corrects an "overvaluation" of fixed assets, we will let that pass. The point that interests us is this: the quotations above are taken from an article written over twenty-five years ago.[2] At least the word "reserve" had its critics then too.

[2] W. M. Cole: "A Confusion of Terms", *The Journal of Accountancy*, March 1927, pp. 196-198.

A PUZZLE FOR AUGUST

When I was on my holidays the weather might have been worse; it rained on 9 days, but whenever it rained in the morning the afternoon was fine, and every rainy afternoon was preceded by a fine morning. There were 7 fine morning and 8 fine afternoons. How long was my holiday?

(*Contributed by a Toronto reader*)

SOLUTION FOR JULY PUZZLE

The conditions given require that the number should be of the form $2a + 1$ and also of the forms $3b + 1$, $4c + 1$, $5d + 1$, $6e + 1$, and $7f$ where a, b, c, d, e, and f are integers. Hence we must have

$2a = 3b = 4c = 5d = 6e.$

The number which is represented by each of these must be a multiple of 2, and of 3, 4, 5, and 6. The least such multiple is 60 and the successive large multiples are 120, 180, 240, 300, etc. The required number must be one of the sequence

61, 121, 181, 241, 301, etc.

and the first one of these which is a multiple of 7 is 301. Hence this is the required number.

PROBLEMS AND SOLUTIONS

Qualified accountants have prepared the solutions appearing in this section, and the solutions reflect the personal views and opinions of their various contributors. Students should not regard them necessarily as models for submission to the examiner. The hope is rather that they will provide a basis for such discussion and explanation of the problems as will make their study beneficial. The editor will welcome discussion of the solutions published.

PROBLEM 1

Intermediate Examination, October 1951

Accounting II, Question 1 (10 marks)

Discuss the advantages of operating as a limited company as opposed to operating as a partnership. (Ignore any considerations regarding income tax.)

A SOLUTION

The liability of members of a limited company is limited to the unpaid portion, if any, of their capital stock subscription. The members of a partnership, on the other hand, have unlimited liability. In the event of bankruptcy of the firm the partners may be called upon to make contributions from their personal resources.

A limited company is a separate legal entity with an existence apart from its shareholders. The company may become involved in litigation without the shareholders having to take part personally in the action. Moreover, the company has a perpetual existence. The death of a shareholder does not affect the company or its ownership of business assets. A partnership firm, on the other hand, is nothing apart from its members. The firm is dissolved upon the death or bankruptcy of a member.

Shares of capital stock in a limited company can be transferred to someone who is willing to purchase them. (In a private limited company the transfer may be subject to the approval of the directors, but in a public limited company there is no restriction on the transfer of fully paid shares.) A partner cannot assign his interest without the consent of all other partners.

A limited company can raise capital by the issue of further shares. A partnership can raise capital only by additional investment on the part of existing members or by the admission of new partners.

The capital of a limited company cannot, by its governing Act, be impaired by the payment of excessive dividends. Unless there is an agreement among members of a partnership on this point, there is no control over the capital of the firm, and certain of the partners may drain the firm.

A shareholder cannot, as such, bind the company contractually by his actions. Partners do, however, have apparent authority to bind their firm over a wide range of every-day business matters. A partner, acting within his apparent authority, may bind the firm even though there is a private agreement among the partners that the partner in question shall not enter into certain types of contract for the firm.

PROBLEM 2

Intermediate Examination, October 1951

Accounting II, Question 2 (10 marks)

The X Co. Ltd. has followed the practice of checking the accuracy of the value of the physical inventory at each year end on the basis of the average results of the two previous years' operations.

The statistics relating to the three years ended 31 Dec 1950 are as follows:

	1948	1949	1950
Sales less returns	$1,300,000	$1,450,000	$1,650,000
Cash discounts on sales	6,225	8,775	9,450
Inventory cost 1st January	133,000	155,000	181,000
Purchases less returns	954,000	1,059,000	1,239,000
Freight on purchases	7,555	7,445	8,095
Cash discounts on purchases	12,450	12,025	15,500

Required:

Estimate the amount of the inventory on hand as at the 1950 year end date, setting out the details of your calculation.

A SOLUTION

THE X CO. LTD.

Calculation of Inventory Valuation at 31 Dec. 1950

	1948	1949	Total	Average
Sales less returns	$1,300,000	$1,450,000	$2,750,000	$1,375,000
Cost of sales				
Inventory 1st January	133,000	155,000		
Purchases less returns	954,000	1,059,000		
Freight on purchases	7,555	7,445		
	1,094,555	1,221,445		
Less closing inventory	155,000	181,000		
	939,555	1,040,445	1,980,000	990,000
			770,000	385,000

Gross profit — % of sales $\frac{385,000 \times 100}{1,375,000} = 28\%$

1950		
Sales		$1,650,000
Cost of goods available for sale		
Inventory 1st January	$ 181,000	
Purchases	1,239,000	
Freight on purchases	8,095	1,428,095
		221,905
Gross profit per above		
28% of $1,650,000		462,000
Therefore closing inventory is estimated to be		$ 240,095

PROBLEM 3

Final Examination, October 1951

Accounting II, Question 1 (10 marks)

The C Co. Ltd. has the following depreciable assets as at the beginning of year 1:

Machinery and equipment	Original Cost	Depreciation Claimed for Tax Purposes
Class 8 — 20%	$318,000	$113,000

Profits and losses before taking into account allowances in respect of capital cost and taxes on income for the years 1 to 10 are to be assumed to be as follows:

Year	Profit	Loss
1	$ 98,000	
2		$75,000
3	32,000	
4	106,000	
5		87,000
6	60,000	
7		15,000

8	60,000
9	90,000
10	110,000

Required:

On the basis of the Income Tax Act and Regulations as at 31st December 1950 (which are to be assumed to be in effect for the full period), prepare a statement showing your computation of the minimum taxes payable by the C Co. Ltd. in respect of the ten-year period.

Editors' note: Details of Sections 31(1) and 36(1) of the *Income Tax Act* were set out on the final page of the examination. Section 36(1) (amended 1950(II)) of the Income Tax Act is as follows:

36(1) Rate. — The tax payable by a corporation under this Part upon its taxable income or taxable income earned in Canada, as the case may be, (in this section referred to as the "amount taxable") for a taxation year is, except where otherwise provided,

(a) 15% of the amount taxable if the amount taxable does not exceed $10,000.00, and

(b) $1,500.00 plus 38% of the amount by which the amount taxable exceeds $10,000.00, if the amount taxable exceeds $10,000.00.

A SOLUTION

THE C CO. LTD.

Statement of Minimum Taxes Payable

for the ten year period . . .

Year	Profit or Loss before Capital Cost Allowance and Taxes	Capital Cost Allowances Claimed	Profit before Taxes	Carry forward or Back	Net Taxable Income	Taxes Payable
1	$ 98,000	$41,000	$ 57,000	B $57,000	—	—
2	(75,000)	32,800	(107,800)	B 57,000	—	—
				F 5,760		
				F 45,040		
3	32,000	26,240	5,760	F 5,760	—	—
4	106,000	20,992	85,008	F 45,040	—	—
				B 39,968		
5	(87,000)	16,793	(103,793)	B 39,968	—	—
				F 46,565		
				F 17,260		
6	60,000	13,435	46,565	F 46,565	—	—
7	(15,000)	10,748	(25,748)	F 25,748	—	—
8	60,000	8,598	51,402	F 17,260	—$ 8,394	—$ 1,259.10
				F 25,748		
9	90,000	6,879	83,121	—	83,121	29,285.98
10	110,000	5,503	104,497	—	104,497	37,408.86
						$67,953.94

Schedule 1 — Capital cost allowances claimed

Cost of machinery and equipment		$318,000
Claimed for tax purposes as at the beginning of year 1		113,000
		$205,000
Maximum allowance and amount claimed	Year 1	41,000
		164,000
	2	32,800
		131,200
	3	26,240
		104,960
	4	20,992
		83,968
	5	16,793
		67,175
	6	13,435
		53,740
	7	10,748
		42,992
	8	8,598
		34,394
	9	6,879
		27,515
	10	5,503
		22,012

Editor's comments: Note that the solution was required to be presented in statement form.

PROBLEM 4

Final Examination, October 1951

Accounting II, Question 2 (15 marks)

As at 31 Oct 1948, the end of its fiscal year, the A Co. Ltd. owned the following assets against which depreciation had been recorded and claimed for tax purposes as follows:

	Assets (at cost)	Accumulated Depreciation as per accounts	Total Depreciation Claimed for Tax Purposes
Buildings	$200,000	$ 60,000	$ 60,000
Machinery	360,000	170,000	160,000
Automotive equipment	90,000	50,000	50,000

The company claimed allowances for depreciation on the straight line basis at the following rates which were allowed by the Minister up to the coming into force of the new capital cost allowance regulations:

Building	5% per annum
Machinery	10% per annum
Automotive equipment	25% per annum

Under the Part XI regulations the buildings are under Class 6, 10%, the machinery is under Class 8, 20%, and the automotive equipment is under Class 10, 30%.

Charges for depreciation in the accounts for the years ending 31 Oct 1949 and 1950 were as follows:

	Year ending 31st October 1949	1950
Buildings	$10,000	$ 8,750
Machinery	40,000	44,000
Automotive equipment	23,375	26,000

On 1 May 1949 five new machines were purchased at a cost of $16,000 each.

On 1 August 1949 two trucks, which had been purchased on 1 Nov 1945 for $8,000 each, were traded in on the purchase of 3 new trucks which cost $10,000 each. The trade-in allowance on the two trucks totalled $5,000. The excess of the trade-in value over the depreciated book value of the trucks was credited to "Profit on disposal of fixed assets" and included in computing the profit before taxes for the year.

On 1 May 1950 a building, which was acquired on 1 Nov 1943 for $100,000, was sold for $25,000. The loss on disposal, as per the accounts, of $45,000, was charged to surplus.

The net profit before taxes on income, as per the accounts, was $150,000 for the year ended 31 Oct 1949 and $180,000 for the year ended 31 Oct 1950.

Required:

A statement reconciling the net profit and taxable income for each year.

A SOLUTION

THE A CO. LTD.

STATEMENT RECONCILING NET PROFIT AND TAXABLE INCOME

for the two years ending 31 Oct 1949 and 1950

	31 Oct 1949	31 Oct 1950
Net profit as shown in the accounts	$150,000.00	$180,000.00
Less profit on disposal of trucks (schedule 1)	1,000.00	—
	149,000.00	
Less additional capital cost allowances claimed in excess of depreciation shown in the accounts (Schedule 4)	10,000.00	
Add excess of depreciation shown in the accounts over capital cost allowances that can be claimed (Schedule 6)		9,347.50
Net taxable income	$139,000.00	$189,347.50

Schedule 1 — Profit on disposal of trucks, 1 Aug 1949

Cost of trucks traded in —2 × $8,000 =	$16,000
Depreciation on trucks traded in (also claimed for tax purposes) 3 years 1 Nov 1945 — 31 Oct 1948 @ 25% p.a. on $16,000 =	12,000
Net book value	4,000
Trade-in allowance	5,000
Profit on disposal	$1,000

Schedule 2 — Loss on disposal of building, 1 May 1950

Cost of building	$100,000
Depreciation on building (also claimed for tax purposes)	
6 years from 1 Nov 1943 to 31 Oct 1949 at 5% p.a. on $100,000	30,000
Net book value	70,000
Proceeds of sale	25,000
Loss on disposal (charged to surplus)	$45,000

Schedule 3 — Maximum capital cost allowance for the year ended 31 Oct 1949

Buildings		
Cost	$200,000	
Depreciation claimed for tax purposes to 31 Oct 1948	60,000	
	140,000	
Maximum allowance (Class 6) — 10%		$14,000
Machinery		
Cost	360,000	
Depreciation claimed for tax purposes to 31 Oct 1948	160,000	
	200,000	
New machines purchased 1 May 1949 — cost	80,000	
	280,000	
Maximum allowance (Class 8) — 20%		56,000
Automotive equipment		
Cost	90,000	
Depreciation claimed for tax purposes to 31 Oct 1948	50,000	
	40,000	
Cost of trucks traded in 1 Aug 1949 less depreciation claimed	4,000	
	36,000	
New trucks purchased 1 Aug 1949 cost — 3 x $10,000 =	30,000	
	66,000	
Maximum allowance (Class 10) — 30%		19,800
Maximum capital cost allowance		$89,800

Schedule 4 — Capital cost allowance that can be claimed for the year ended 31 Oct 1949

Total allowance that can be claimed:	
Charges for depreciation in the accounts	
To 31 Oct 1948	$280,000
For the year ended 31 Oct 1949	73,375
	353,375

Depreciation claimed for tax purposes to 31 Oct 1948	270,000	
		$83,375

Amount by which depreciation claimed is less than maximum allowance:

Maximum allowance (Schedule 3)	89,800	
Total allowance that can be claimed	83,375	
		$6,425

Capital cost allowances that can be claimed:

Building ($14,000 — $6,425) *	$ 7,575
Machinery—maximum allowance	56,000
Automotive equipment—maximum allowance	19,800
	$83,375

Excess of capital cost allowances that can be claimed over charges for depreciation in the accounts, year ended 31 Oct 1949

Capital cost allowances that can be claimed	$83,375
Charges for depreciation in the accounts	73,375
	$10,000

* The capital cost allowance which is less than maximum need not have been taken on buildings. It might have been taken on the other assets instead.

Schedule 5 — Maximum capital cost allowance for the year ended 31 Oct 1950

Buildings		
Cost	$200,000	
Depreciation claimed to 31 Oct 1948	60,000	
	140,000	
Depreciation claimed, year ended 31 Oct 1949 (Schedule 4)	7,575	
	132,425	
Proceeds from sale of building 1 May 1950	25,000	
	107,425	
Maximum allowance (Class 6) — 10%		$10,742.50
Machinery		
Cost	$360,000	
Depreciation claimed to 31 Oct 1948	160,000	
	200,000	
New machines purchased 1 May 1949	80,000	
	280,000	

Depreciation claimed, year ended 31 Oct 1949 (Schedule 4)	56,000	
	224,000	
Maximum allowance (Class 8) — 20%		44,800.00
Automotive equipment		
Cost	90,000	
Depreciation claimed to 31 Oct 1948	50,000	
	40,000	
Cost of trucks traded 1 Aug 1949 less depreciation claimed	4,000	
	36,000	
New trucks purchased 1 Aug 1949	30,000	
	66,000	
Depreciation claimed, year ended 31 Oct 1949 (Schedule 4)	19,800	
	46,200	
Maximum allowance (Class 10) — 30%		13,860.00
Maximum capital cost allowance		$69,402.50

Schedule 6 — Capital cost allowance that can be claimed for the year ended 31 Oct 1950

Excess of charges for depreciation in the accounts over capital cost allowances that can be claimed; year ended 31 Oct 1950:		
Charges for depreciation in the accounts	$78,750.00	
Maximum allowance (Schedule 5)	69,402.50	
		$ 9,347.50
Capital cost allowances that can be claimed (maximum allowances, per Schedule 5)		
Buildings		10,742.50
Machinery		44,800.00
Automotive equipment		13,860.00
		$69,402.50

Editor's comments:

1. Depreciation reserves can be adjusted between classes so that an average on one class can be transferred to another class.
2. The amount of depreciation claimable in one year was limited to the amount previously or already shown in the books.
3. The loss realized on the disposal of the building ($45,000) was charged to surplus. It should not, therefore, be added back to profit shown in the accounts or used as a basis for depreciation calculations.
4. The new regulations were effective for companies whose financial year ended in 1949 and combinations of the straight line and diminishing balance methods of depreciation could not be used in that financial year.